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before

Committee on Oversight and Government Reform
Subcommittee on Domestic Policy

Honorable Dennis Kucinich, Chair

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Good morning Chairman Kucinich, Ranking Member Issa and members of the Subcommittee for inviting me here today to testify on issues concerning the mortgage market in the U.S. The issues that will be discussed today are critically important, not only to the housing conditions and credit histories of millions of directly impacted American families, but also to the economic sustainability of the neighborhoods and communities in which these families reside, and to the long-term viability of U.S. housing and financial markets.

I am an Associate Professor of City and Regional Planning at Georgia Institute of Technology in Atlanta, where I conduct research on housing and mortgage markets. I also teach graduate courses in real estate finance, statistics and other courses. I have been conducting research on U.S. mortgage markets for more than 10 years now. I have also done substantial research on the housing markets and neighborhood economies more generally.

As some context for the statistics that you are hearing today, I would like to relay a slightly longer historical view on the issue. In the early to middle 1990s, after decades of decline of older urban neighborhoods, it appeared that, in many modest-income neighborhoods, things were really beginning to really turn around. There was a strong sense that groups like NeighborWorks organizations, community development corporations, and community development financial institutions were making real progress in reviving the housing stock and economies of neighborhoods and communities around the country. To their credit, some banks – often in partnership with local community organizations – were beginning to become much more

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active in lending to these communities. The revitalization of housing and small business markets was happening in many places. Indeed, census data show that, from 1990 to 2000, there was an overall decline in geographically concentrated poverty in U.S. metropolitan areas.[2] In many cities, the population losses of the 1970s and 1980s slowed or even reversed, and many observers saw real hope that the urban trauma of earlier decades had come to an end.

However, many of us who followed housing patterns began to notice a development in home finance in the middle 1990s that caused some concern. While some banks and thrifts were doing more to serve urban communities – especially within their Community Reinvestment Act assessment areas -- a set of different lenders, many of which were new firms or formerly niche lenders that were growing into much larger firms, was also beginning to target these underserved markets. These communities were now beginning to be supplied with a new form of high-priced credit, often involving disadvantageous terms that were rarely employed in the conventional, prime market. Many borrowers were being charged very large up-front fees or sold ancillary financial products for which they did not appear to have any use. Moreover, it appeared that, in many cases, borrowers were being given loans that they had little prospect of being able to repay right from the get-go. Some loans contained terms that would make default more likely and refinancing to more affordable products more difficult. In other cases, borrowers that would qualify for traditional loans at conventional, low rates, were being given loans with excessive fees or interest rates. Frequently, traditional ability-to-pay underwriting practices appeared to be being discarded by some of these new lenders.

Well, ten-plus years later, it is clear that the subprime market and some parts of the prime market are in many respects fundamentally dysfunctional – both from the perspectives of affected borrowers and the communities impacted by large numbers of subprime and aggressive, exotic mortgages.

The industry publication, *Inside Mortgage Finance*, shows that subprime lending grew from approximately $35 billion in 1994 to $665 billion in 2005. We now have a flood of credit, much of which is structured to the detriment of the borrower and to the benefit of the credit

[2] Jargowsky, P. (2003). Stunning progress, hidden problems: The dramatic decline of concentrated poverty in the 1990s. Brookings Institution Center on Urban and Metropolitan Policy. At http://www.brookings.edu/es/urban/publications/jargowskypoverty.pdf.

arrangers. This flood of credit is distorting housing markets and causing negative spillovers from directly impacted borrowers onto neighbors and communities.

A now substantial body of research points to severe problems in the subprime market. There have been at least three sorts of problems. First, there has been ample documentation of the rise in abusive practices and terms, which have been associated primarily with the subprime industry.[3] Second, there is compelling body of evidence that, even after controlling for credit scores and other factors, minority and, especially, African American households are more likely than similarly situated white households to receive subprime mortgages.[4] Subprime disparities are particularly glaring at the neighborhood level, with subprime lenders often accounting for much larger shares of home loans in predominantly minority neighborhoods.[5]

The third concern, which is now being amplified as housing appreciation stalls in many places, is that the sector is responsible for excessive foreclosures, with subprime foreclosure rates at over 10 to 15 times those of prime loans.[6] While foreclosures increased in all sorts of neighborhoods, the greatest increases in the late 1990s were generally in neighborhoods with high proportions of lower-income and minority residents.[7]

Foreclosures are the clearest manifestation of how overly aggressive and irresponsible lending harms neighborhoods and communities. The true, complete costs of foreclosures are born mostly by the borrowers and the communities in which they live. Neighborhoods see values and confidence decline. My own research shows that, even after controlling for other neighborhood characteristics, higher foreclosure levels significantly suppress the values of

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[3] U. S. Department of Treasury and U.S. Department of Housing and Urban Development. (2000). Curbing predatory home mortgage lending. Washington, DC: Author.

[4] See, for example, Gruenstein-Bocian, D., Ernst, K., & Li, W. (2006). *Unfair lending: The effect of race and ethnicity on the price of subprime mortgages.* Washington, DC: Center for Responsible Lending. May 31, and Nichols, J. Pennington-Cross, A., & Yezer, A. (2005). Borrower self-selection, underwriting costs, and subprime mortgage credit supply. *Journal of* Real Estate Finance and Economics, 30 (2), 197-219.

[5] See, for example, Calem, P., Gillen, K., & Wachter, S. (2004). The neighborhood distribution of subprime mortgage lending, J*ournal of Real Estate Finance and Economics, 29 (4),* 393-410, and Wyly, E., Atia, M., & Hammel, D. (2004). Has mortgage capital found an inner-city spatial fix? *Housing Policy Debate 15* (3), 623-685.

[6] See, for example, Immergluck, D. and Smith, G. (2005). Measuring the effects of subprime lending on neighborhood foreclosures: Evidence from Chicago. *Urban Affairs Review* 40: 362-389; Schloemer, E., Li, W., Ernst, K., & Keest, K. 2006. *Losing ground: Foreclosures in the subprime market and their cost to homeowners.* Washington, DC: Center for Responsible Lending, at http://responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf; Quercia, R., Stegman, M. & Davis, W. 2005. The impact of predatory loan terms on subprime foreclosures: The special case of prepayment penalties and balloon payments. Chapel Hill, NC: Center for Community Capitalism at the University of North Carolina at Chapel Hill, at http://www.kenan-flagler.unc.edu/assets/documents/ki_CCC_PreventiveServicing.pdf

[7] Immergluck and Smith, (2005). supra.

nearby properties.[8] For every foreclosure within one-eighth of a mile of a single-family home, property values are expected to decline by approximately 1 percent. For neighborhoods with multiple foreclosures, then, property values are impacted even more. In Chicago, we estimated the cumulative impact of two years of foreclosures on property values to exceed $598 million, for an average of $159,000 per foreclosure.

Cities, counties and school districts then lose tax revenue due to lower values. Moreover, William Apgar and Mark Duda of the Harvard Joint Center for Housing Studies found that the direct costs to city government in Chicago – not counting those due to falling property values -- involve more than a dozen agencies and two dozen specific municipal activities, generating governmental costs that in some cases exceeded $30,000 per property.[9] And when foreclosures catalyze true property abandonment, these properties can become blighted and havens for crime, begetting a spiral of severe neighborhood decline.

As the subprime industry continued to grow rapidly in recent years, its appetite for pushing product to a wider and increasingly suburban market swelled. The result has been that foreclosures have increased substantially in many suburban communities. Figure 1 shows that, in the core five-county Atlanta market, for example, foreclosures increased from just over 8,200 in 2000 to more than 23,000 in 2006, an increase of over 180 percent. Moreover, the county with the highest (258%) rate of increase – Gwinnett County – is a predominantly middle-income, county with an increase of 258 percent. All five counties (all of which are majority suburban) saw increases in foreclosures of more than 135 percent between 2000 and 2006. And I fully expect these numbers to grow even more in 2007 as many adjustable rate loans reset to much higher rates.

Beyond the costs imposed by foreclosures and distressed sales, overly aggressive lending –especially in the subprime market -- hurts neighborhoods by encouraging speculation and driving up property values to unsustainable levels, creating essentially bubble-neighborhoods. Such lending is sometimes accompanied by high levels of appraisal fraud and associated property flipping in which mortgage brokers and others orchestrate schemes to extract large

[8] Immergluck, D. and Smith, G. (2006). The external costs of foreclosure: The impact of single-family mortgage foreclosures on property values, *Housing Policy Debate* 17: 57-79.

[9] Apgar, W. and Duda, M. (2005). *Collateral damage: The municipal impact of today's mortgage foreclosure boom*. Washington, DC: Homeownership Preservation Foundation. May 11. At http://www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/Apgar-DudaStudyFinal.pdf.

sums from lenders by obtaining fraudulent appraisals, allowing them to buy and sell properties for much higher rates of appreciation than can be justified by any underlying fundamentals.

When lenders redesign loan products so that they dramatically – but only temporarily -- reduce the monthly mortgage payment with the primary purpose of supposedly providing more "purchasing power," some of this increased purchasing power will be extracted in the form of higher prices for homes, especially in markets where demand for housing is strong. As long as this lending – and borrowing – is sustained, values may continue growing. However, aggressive lending is partly based on continuing appreciation, but this appreciation is in turn dependent upon the continuation of aggressive lending. If either the lending or the valuations stall in some way, the negative impact on credit availability and property values are mutually reinforcing, which can result in a spiraling down of values and neighborhood confidence.

In a recent research paper, University of Pennsylvania Wharton School professors Andrey Pavlov and Susan Wachter find that neighborhoods in which more aggressive products are highly prevalent, prices are substantially more volatile. Pavlov and Wachter argue that the prevalence of these loans "puts the market at risk as their originations tend to decline on a relative basis faster than the traditional more conservative instruments in the face of a negative demand shock in the underlying market."[10] More specifically, in looking at the impacts of high levels of adjustable rate mortgage (ARM) lending on neighborhood price trends, they find that, for each one percent increase in the share of loans that were ARMs when the market peaked, the amount of price decline increases by 1.3 percent.

So, aggressive lending can push values up at first, but then pushes them down much further when the inevitable market downturn occurs. Property appreciation that is built upon financing gimmicks and short-term teaser rates is not real, sustainable appreciation and, in the long run, discourages the smooth functioning of housing markets and neighborhood economies.

Thus, overly aggressive lending is not just an issue between buyers and sellers of credit. It has serious implications for homeowners and residents of impacted communities who had no role in the credit decision. Even if one does not believe it is government's role to protect vulnerable borrowers (and I believe it is), it is hard to argue that there is no role for government in regulating practices and products that can do so much harm to entire communities.

[10] Pavlov, A. and Wachter, S. (2006). Aggressive Lending and Real Estate Markets. Unpublished manuscript. December 20. Page 13.

The Spread of Foreclosure Problems and the Destabilization of Housing Markets

We are now seeing that the stalling of the aggressive lending-appreciation cycle is having significant impacts on entire regional housing markets. My recent research shows that, from 1997 to 2003, while home purchase lending by subprime firms grew in all metropolitan areas with a population of at least 500,000, such lending grew substantially faster in some large metros than others.[11] Many Californian metros, in particular, experienced very large increases and, in general, metropolitan areas with larger home prices– saw larger increases in subprime lender share.

Given that some of these high-appreciation communities have, at least until recently, not experienced the large numbers of foreclosures associated with subprime lending in other markets, I believe we can only assume that the foreclosure problem will be getting far worse – and more widespread – before it gets better. I have compared early 2006 foreclosure activity across 81 large metropolitan areas to subprime activity in the same markets in a preceding year (2003) .[12] Figure 2 plots this relationship. The dashed and dotted ovals indicate that large metro markets cluster along two distinct axes running northwest on the chart at different angles. In the markets in the dashed oval, foreclosure rates are much higher for cities with high levels of subprime lending. The metro markets in the dotted oval experience exhibit a weaker, though still positive relationship. Most of the metros in the steeper, dashed oval were experiencing weaker appreciation trends as of early 2006.

The difference in these two groups of markets is that, as of early 2006, the markets in the dotted oval were experiencing relatively high levels of appreciation. (We know that things are now changing for the worse in many of these markets.) If a homeowner in a high-appreciation market runs into trouble paying her mortgage, she can sell the house or refinance the property rather than face foreclosure. So, while appreciation continues at a fast pace, foreclosures tend not to reach severe levels. However, when prices in these areas stall or decline, foreclosures follow and property values may fall more precipitously than in markets where values had not gotten so hot. In fact, Schloemer and her colleagues use Moody's housing price forecasts to predict future foreclosure trends and suggest that many high value markets – especially many in

[11] Immergluck, D. (2007). From the subprime to the exotic: Expanded mortgage market risk and implications for metropolitan communities and neighborhoods. Unpublished manuscript. Available upon request.

[12] Ibid.

California – are likely to experience some of the highest foreclosure rates in the country in coming years.[13] Moreover, as was the case in their neighborhood analysis, Pavlov and Wachter find that metropolitan markets with high levels of aggressive lending tend to experience greater declines in value when their markets cool. More specifically, they write, "The proportion of ARMs on the top of the market has a large and significant impact on the subsequent price decline."[14]

Many if not most exotic and subprime mortgages involve adjustable interest rates, especially those made in the 2003 to 2005 period, when exotic mortgage products became so popular. Much of the increase in ARM activity in recent years has been attributed to exotic products and subprime loans. The Federal Housing Finance Board's Monthly Interest Rate Survey (MIRS) of major lenders tracks the prevalence of ARMs for all home purchase loans. Figure 3 indicates the shares of home purchase loans that were ARMS from 1990 to 2004. [Because large loans that exceed GSE purchasing limits ("jumbo" mortgages) are more likely to be ARMs, the figure distinguishes ARM share for jumbo versus nonjumbo loans.] This chart shows that ARM share fluctuates widely. Traditionally, as rates for fixed-rate loans fall, the short-term savings that ARMs can provide decline, and fixed-rate loans increase. This was the case from 1990 to 1992. As rates rose from 1998 to 2000, ARMs increased as expected. However, from 2001 to 2003 interest rates generally fell and ARMS held steady for jumbo loans and increased for nonjumbo mortgages. Then, although rates remained relatively flat, ARMs increased dramatically in 2004, so that ARM share reached 71 percent of jumbo loans and 31 percent of nonjumbo loans. Moreover, the MIRS data most likely understates the growth in ARM share in later years, especially in the subprime market and for loans with teaser rates.[15]

The Federal Housing Finance Board breaks out historical MIRS data on ARM share for some of the largest metropolitan areas. Figure 4 plots the proportion of conventional home purchase loans in 2004 that were ARMs against the 2004 average home purchase price (for properties bought with conventional loans) for 31 large metropolitan markets The plot indicates that metros with higher sales prices tend to see higher ARM share.

[13] Schloemer et al., supra.

[14] Pavlov and Wachter, supra, page 14.

[15] The MIRS data omits some significant segments of the mortgage market, including refinance loans, very large loans, those made by specialized subprime lenders, and in latter years, those with interest rates below 2.75 percent, which would include many ARMs with teaser rates. This latter omission is particularly relevant in recent years with the advent of exotic mortgages and the relatively low interest rate environment.

The increase in exotic mortgages has been portrayed by some as merely being driven by rising property values, as home buyers "demand" such loans to lower the initial debt service of increasingly expensive properties. However, when such products allow buyers to "stretch" farther – often too far – they actually fuel the demand for higher cost homes and become as much a cause as an effect of higher home prices. Basic urban economics tells us that land is relatively fixed in supply, so increasing the size of loans that borrowers can afford – especially in tight housing markets – is likely to result in higher housing prices.

In fact, many lenders have promoted adjustable rate and exotic loan products as a means for buyers to afford larger homes. In effect, many lenders in the last few years began competing much more based on maximizing the borrower's loan size than on interest rate or similar factor. This is a fundamental shift in the mortgage market – and not a healthy one.

As long as they expect values to continue to rise overall, some lenders will be willing to take on added repayment risks associated with more highly leveraged borrowers, because they are confident that properties will appreciate sufficiently to cover losses. The private mortgage insurer, PMI, Inc., has developed an index measuring the risk of property values declining in the next two years (called "market risk").[16] Figure 5 combines the 2006 PMI market risk index with MIRS data for the same 31 metropolitan markets. The chart shows two clusters of metros – one with market risks below 20 percent and the other with market risks above 30 percent. Most of the higher-risk metros have relatively high ARM shares. Even for the lower-risk cluster, higher ARM share appears to be related to market risk. This chart should give policy-makers significant cause for concern. When interest rates reset, many borrowers could find themselves struggling to meet their mortgage obligations. If housing appreciation can be maintained in such an environment – which is in question – then large increases in foreclosures may not result, although increased mobility may still occur as some homeowners are forced to sell their homes. Higher foreclosure rates, however, are likely to spur lower housing values which could, in turn, prompt difficulties in refinancing loans or in selling properties.

[16] The PMI Market Risk Index is based on measures of housing price escalation, employment growth, and local housing market affordability. PMI, Inc. (2006). *Economic and real estate trends.* Summer. At http://www.pmigroup.com/lenders/media_lenders/pmi_eret06v3s.pdf.

Implications for Federal Policy

First, it seems a sad commentary on state of the federal regulatory regime that federal agencies have – at least until very recently-- been more willing to act to control exotic mortgages in the prime market while doing little to protect the even more vulnerable borrowers in the subprime market. The regulators deserve credit for issuing earlier guidance on alternative mortgage products like interest only and payment-option loans. But they should go much further in two key respects. They should go beyond guidance and issue proscriptive regulations strictly limiting the most aggressive products and practices. Secondly, they need to include subprime hybrid ARM products such as 2/28s and 3/27s *explicitly* in this sort of guidance. (They have very recently proposed doing so.) These products effectively involve deferring interest from the teaser period – where the nominal rate is artificially suppressed to the post-reset period. The rate adjustment is effectively not any different than what happens when an interest-only or negative amortization loans converts to an amortizing product, except that the payment increase – or shock – will often be much higher in the case of the subprime loan. Regardless of whether we are talking about alternative products in the prime market or subprime hybrid products, these loans should be underwritten at the fully indexed interest rate. The Center for Responsible Lending has documented that large subprime lenders frequently underwrite loans at rates either at the initial teaser rate or hundreds of basis points below the fully indexed rate.[17] The announcement recently by Freddie Mac that it would now require underwriting at the fully indexed rate is certainly a welcome development.

Second, the market has shown that it does not transfer risk appropriately across different agents in the lending process. Brokers and originators are able to pass poorly underwritten loans off to packagers of special purpose investment vehicles who are, in turn, able to tolerate losses as long as their investors are receiving adequate average returns from their entire portfolio of mortgage-backed-securities. And when housing markets overall are appreciating fairly rapidly, high levels of risk can be tolerated –at least in the short run. Moreover, the de-localization of credit markets has meant that geographically diversified lenders can tolerate very high foreclosure rates in particular communities while maintaining nationwide rates that they are able to cover through high margins and aggressive growth.

[17] See written testimony of Martin Eakes, Center for Responsible Lending, before the Senate Committee on Banking Housing and Urban Affairs, February 7, 2007. At http://www.responsiblelending.org/pdfs/martin-testimony.pdf.

In order to return sanity to the mortgage market and make homeownership more sustainable, there is an urgent need for making all actors in the credit supply chain more accountable for their roles in the mortgage process. Liability for reckless lending needs to follow the loan from broker to lender to investor. Investors should not be able to hide behind a veil of ignorance. Nothing will create accurate information and reduce fraud better than exposing investors to the downside risk of providing capital to irresponsible lenders. As it stands now, the bulk of the costs of overly aggressive and irresponsible lending accrue to the borrowers and the local communities in which they reside. When the impacts on housing markets reach a tipping point and values begin to fall, eventually some lenders with the highest risk profiles will pay the price – which is what we have begun to see in the last few months. But the hyper-boom-bust cycle of the subprime market is not good for America's homeowners or communities. It fuels instability in household budgets, neighborhoods, and housing and financial markets more broadly.

Regulation must work to shift a much more substantial share of the costs of irresponsible lending to the supply side of the market – to lenders, brokers, and, especially, the Wall Street investors that feed the beast of irresponsible credit. On the origination side, mortgage brokers should bear fiduciary responsibility to borrowers. If stockbrokers have an obligation to act in accordance with the interests of their clients, should not mortgage brokers – who serve a much broader cross section of the American public – have the same obligation?

Third, subprime loans should be regulated in a way that returns this major segment of the mortgage market to one where underwriting is once again based fundamentally on an ability-to-pay rationale. Debt-to-income ratios should be calculated at or very near the fully indexed rate for adjustable rate loans. Moreover, the growth of low- and no-documentation loans in the subprime market has given far too much opportunity for brokers and originators to commit or facilitate fraud. The Mortgage Asset Research Institute, Inc., an industry consultant that tracks mortgage fraud, cites a compelling piece of lender research that corroborates the notion that stated-income loans are rife with problems:

> One of MARI's customers recently reviewed a sample of 100 stated income loans upon which they had IRS Forms 4506. When the stated incomes were compared to the IRS figures, the resulting differences were dramatic. Ninety percent of the stated incomes were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%.[18]

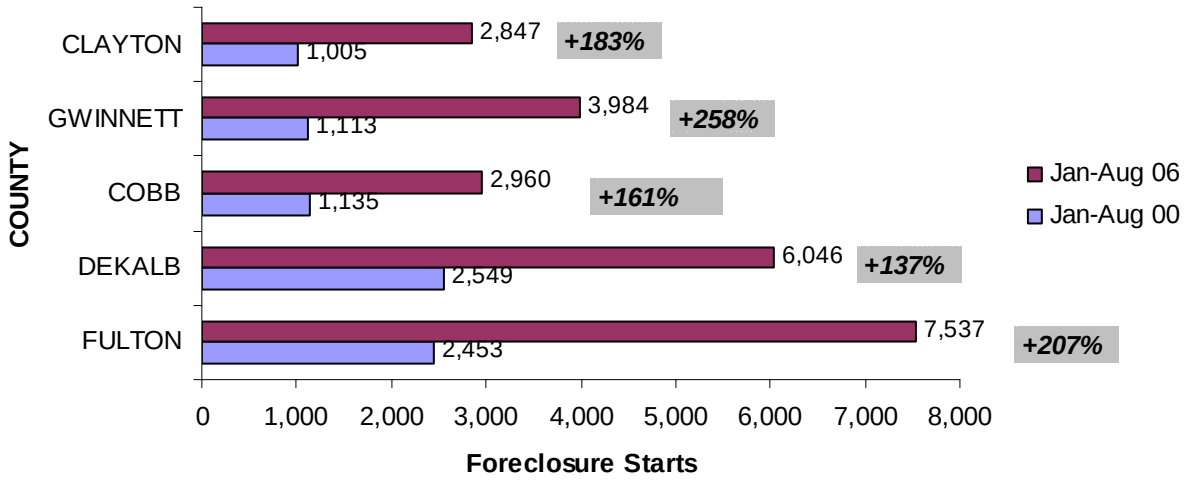
Finally, while I share the desire of many who would like to see a stronger, basic set of federal regulations for subprime and alternative mortgage products, I do not think that federal preemption of stronger state laws is a necessary or appropriate quid-pro-quo for such regulation. The notion that mortgage markets are significantly impeded by differential state regulatory regimes is not consistent with the existing evidence. The research on state predatory lending laws has shown that states with predatory lending laws can actually encourage healthier mortgage markets. Moreover, lenders have always dealt quite well with different state foreclosure regimes. There is no compelling evidence that the state-based foreclosure regime has had any significant retarding effect on the mortgage market. (At the same time, I do believe that there are states – including my own -- in which homeowner protections in the foreclosure process are woefully inadequate.)

Federal law should be strengthened to provide a structurally sound floor of basic mortgage regulation – one not based solely on the confusing babble of dozens of disclosure documents that even professors who teach real estate finance have difficulty understanding. A more stable mortgage and housing market requires a much firmer federal regulatory foundation. Then, states should then be able to exercise their prerogative to supplement this regime with additional protections for their citizen homeowners.

Thank you again for this opportunity to offer my comments on this very important topic.

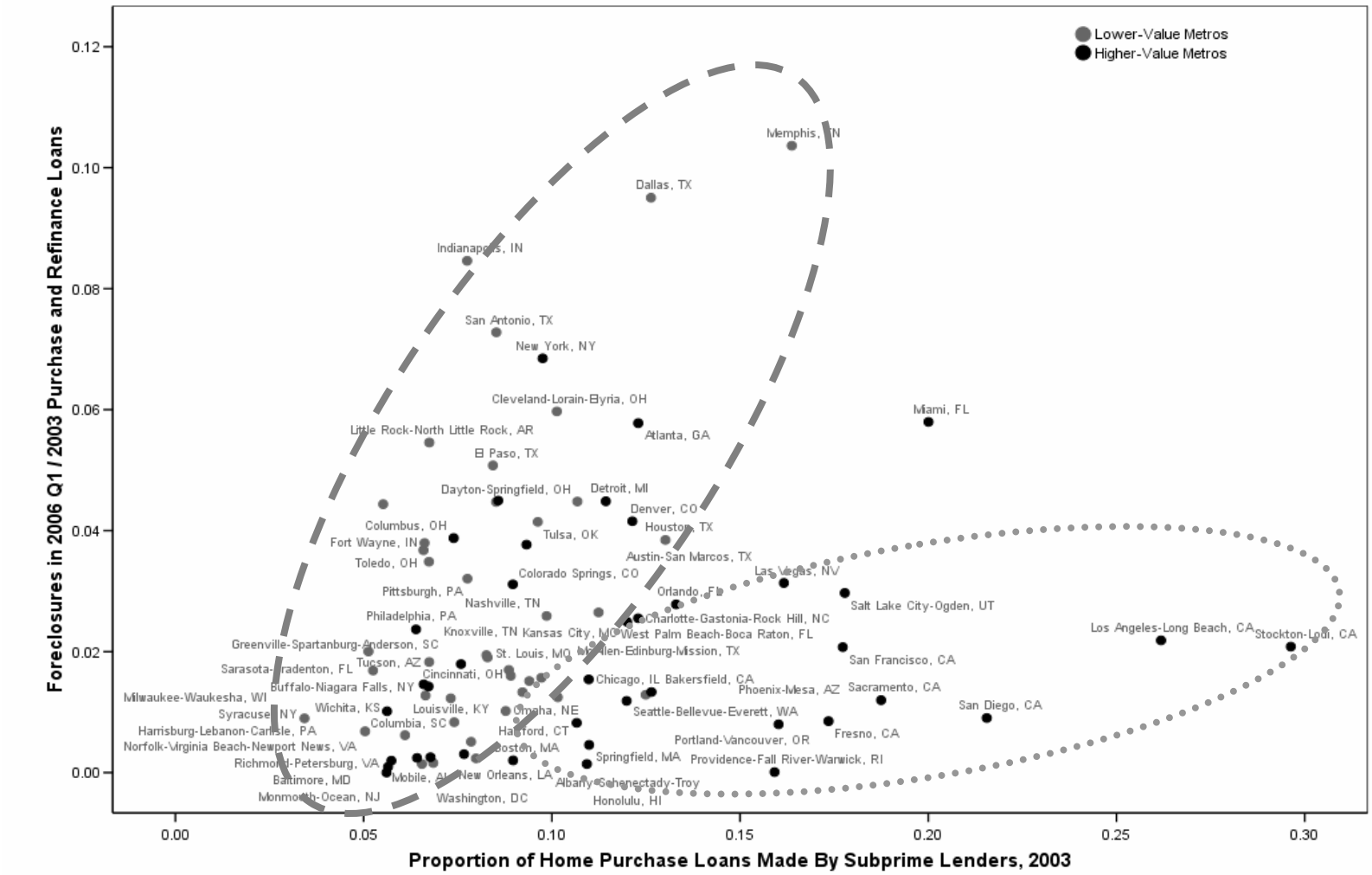
[18] Sharick, M., Omba, E., Larson, N., Croft J. D., 2006. Eighth periodic mortgage fraud case report to Mortgage Bankers Association. April. Athttp://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf.

Figure 1. Growth in Foreclosures in the Five Core Atlanta Metro Counties, 2000-2006 (first 8 months 2000 to first 8 months 2006 comparison)



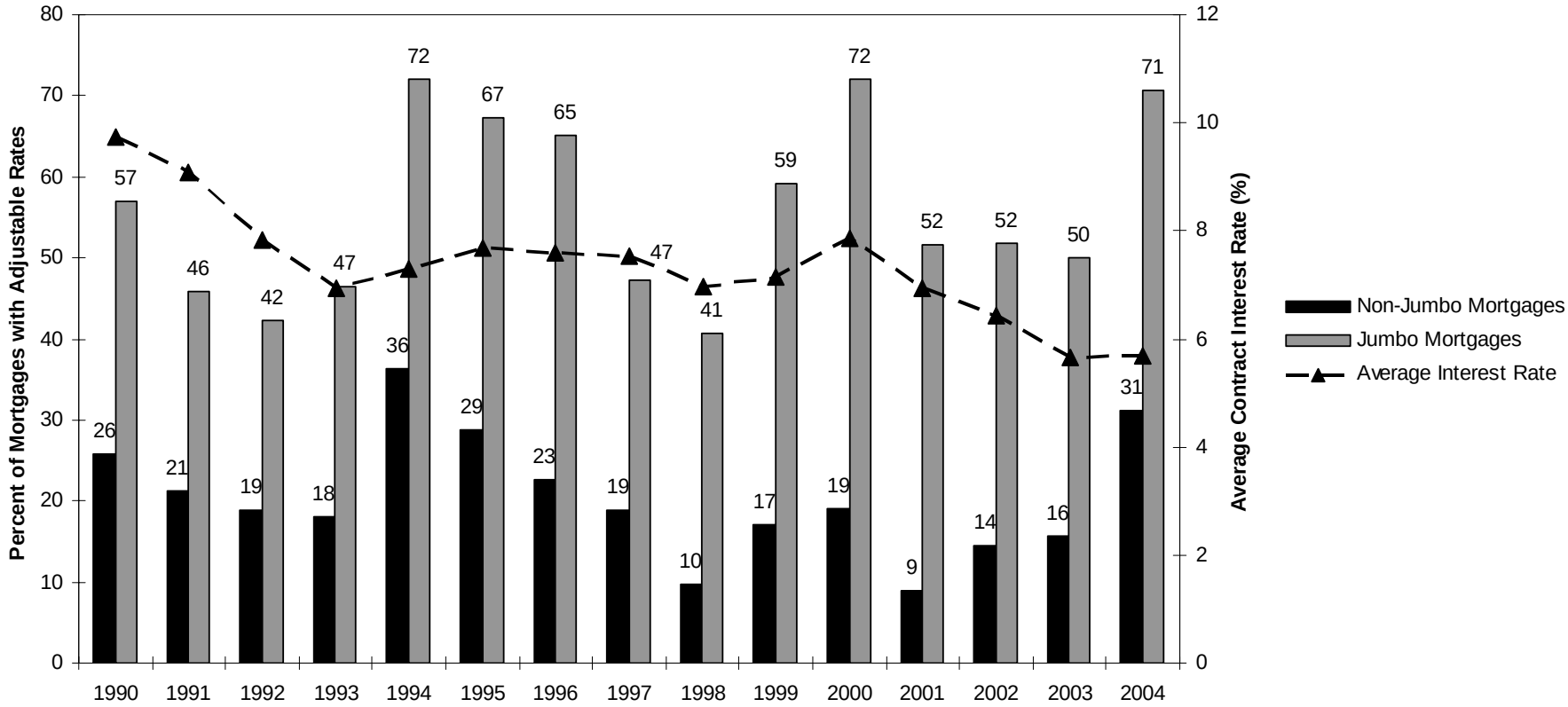
Source: Atlanta Foreclosure Report; EquityDepot.net, 2006

Figure 2. Foreclosure Filing Rate by Subprime Lender Share of Home Purchase Loans for 81 Large Metros



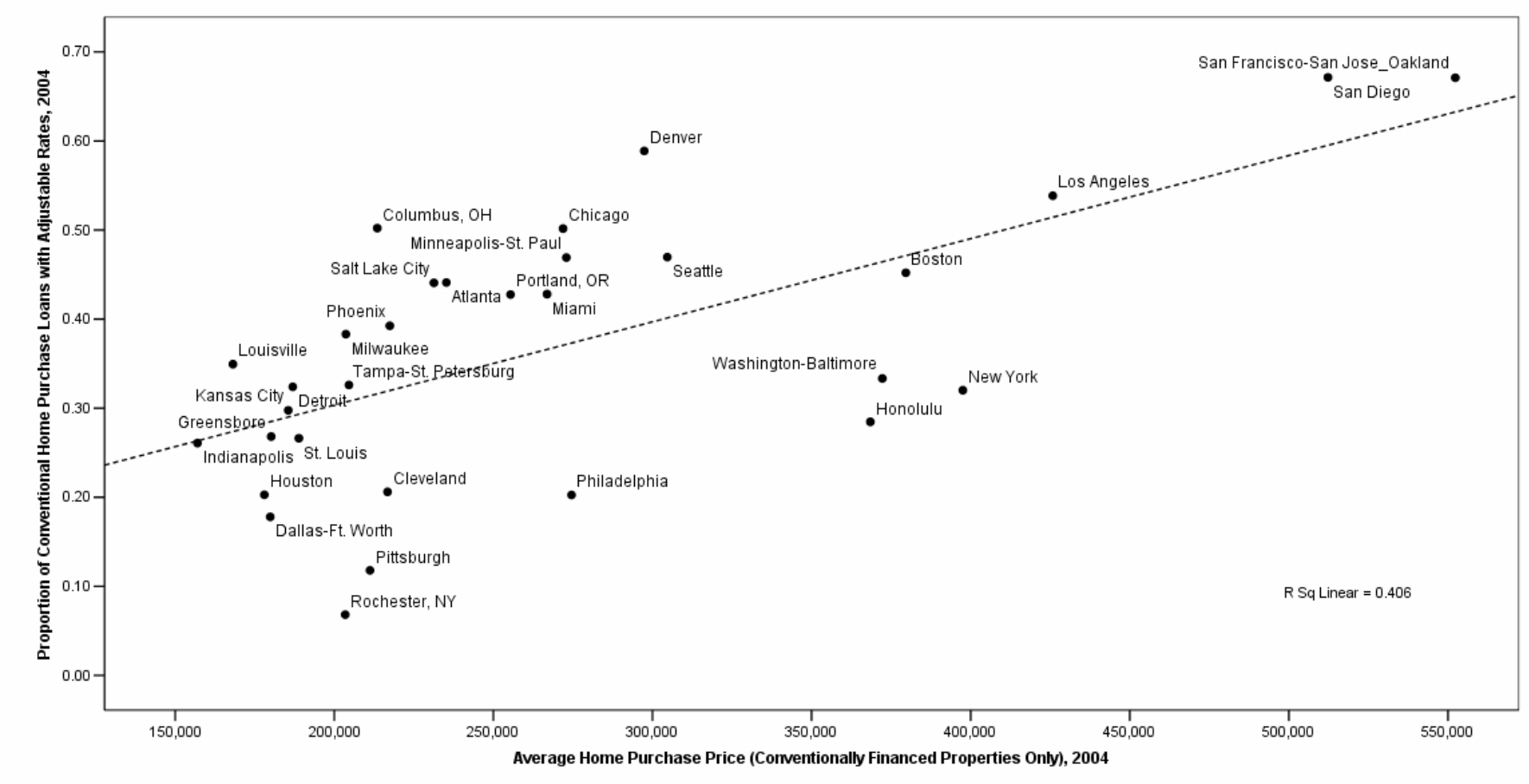
Source: RealtyTrac, Inc. (2006); Authors calculations of Home Mortgage Disclosure Act data.

Figure 3. Proportion of Conventional Mortgages with Adjustable Rates by Jumbo/Nonjumbo Status, 1990-2004



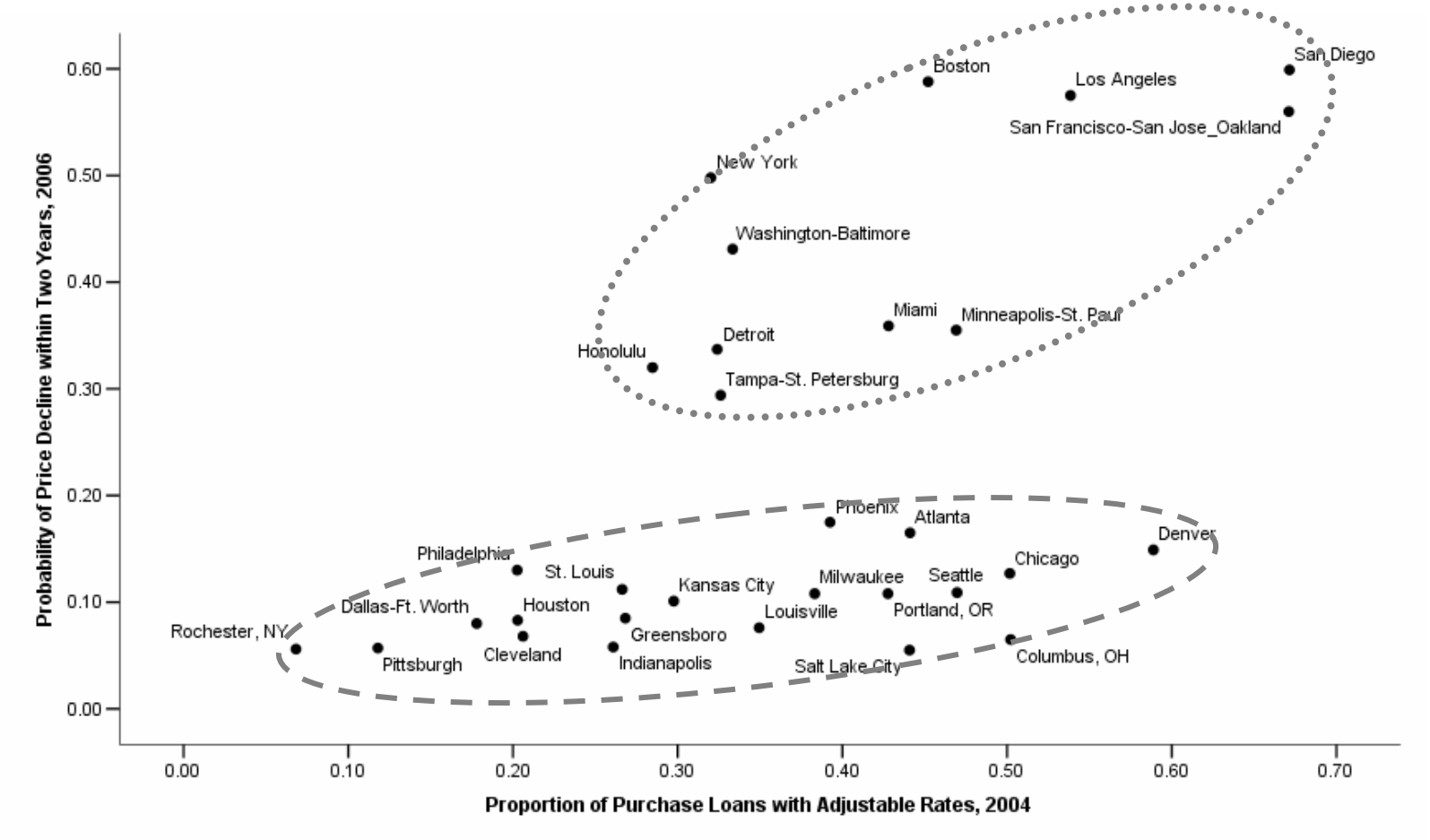
Source: Federal Housing Finance Board, Monthly Interest Rate Survey

Figure 4. Proportion of Conventional Mortgages with Adjustable Rates by Average Home Purchase Price, 2004



Source: Federal Housing Finance Board, Monthly Interest Rate Survey

Figure 5. Adjustable Rate Mortgage Presence and Overvaluation Risk, Large Metro Markets



Source: PMI, Inc. Market Risk Index; Federal Housing Finance Board, Monthly Interest Rate Survey